DOW THEORY LETTERS INC.

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THE MARKET: The emphasis in this issue of Dow Theory Letters will be on money. For many months I have been calling attention to the dramatic events which have been building in the money markets. As predicted, it is the U. S. Government with its ferocious appetite for money which has become the world's leading competitor for funds. And make no mistake about it, when Uncle Sam needs cash he is going to get it; he is going to take on all comers, and he is going to pay the price. I do not believe that one out of a hundred investors comprehends the meaning of what is now going on in the money market, and this is the reason I am stressing it. Investors tend to read isolated bits of the story in the newspapers (see accompanying clippings), but the overall picture is undoubtedly escaping them. The picture is this; never before in U. S. history has an aging boom (a boom which has been producing record highs in the stock market and the economy) run head on into an expanding war. Never before have a wildly spending public, a mountainous national debt, a welfare state (committed to a "Great Society"), a war and a capital goods boom converged.

The result — an all out scramble for money, a struggle for dollars which is going to affect every state, county, city, corporation, family and individual in the nation. Or, as a hard-nosed investor, you can put it this way, the movements in the money market now promise to provide savers (and these with cash) with the biggest income bargains seen in a generation. Here are some of this week's extraordinary developments: this week I counted 14 of the 40 listed U. S. Treasury bonds at yields of 4.7% with three of them at 4. 8% (remember, this is only a fraction below 1960's "magic figure" of 5%). The D-J Municipal (tax-free) bond yields have risen to 3. 62%, highest level in five years. The bellwether 91-day Treasury bills are providing a new post-1960 yield peak of 4. 5%. The nation's savings institutions are girding for a major battle for money, and on December 15 the Wall Street Journal carried its first dramatic money advertisement (see reduction), the announcement by a California state bank (not a savings & loan) that it will pay 5% interest on open accounts of $1000 or more held for 90 days. As far as this observor is concerned, this ad was like the crack of the starter's gun; the fight for funds is moving into "high gear."

Call the above my own personal opinion of the picture. Call it "slanted news" if you wish. But what of Dow's Theory, what is the cold impersonal view of the situation as seen from the standpoint of the Averages?

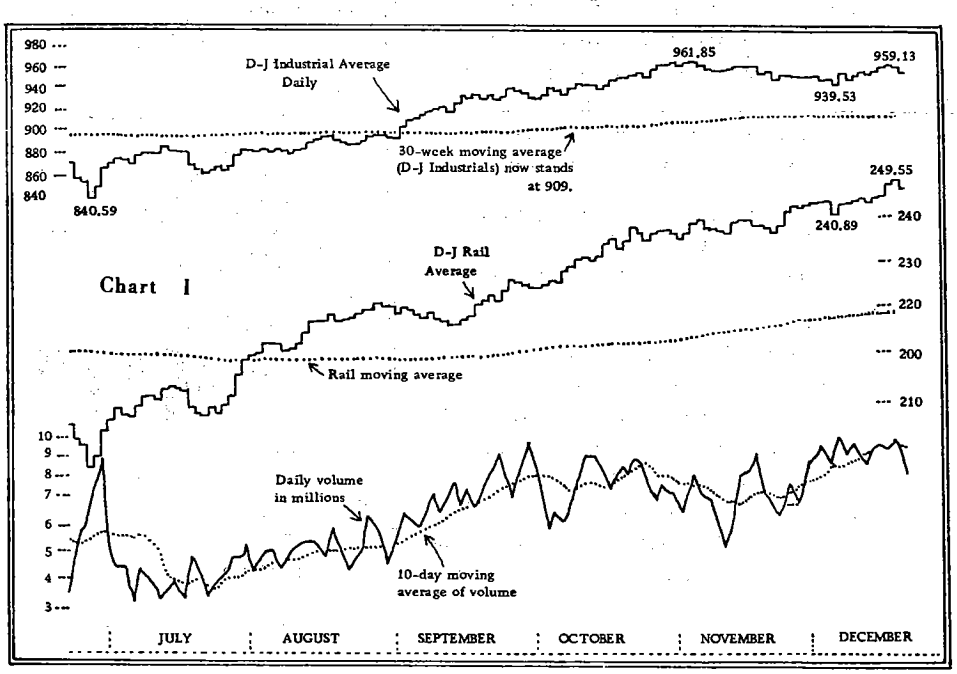


Chart I

On November 4 the Industrial Average recorded an all-time high of 961. 85. During the five weeks that followed, Industrials and Rails diverged, Rails pushing to successive highs while Indus — trials retreated. Noting that under Dow Theory a trend is taken to remain in force until proved otherwise, these Letters have classified both the primary and secondary trends as bullish. "The secondary trend has remained bullish," stated Letter 308, "it will continue to be classified as bullish

Bank-S&L Rivalry Likely To Intensify

Financial institution executives here watched developments yesterday in what may be shaping up as a war between commercial banks and savings and loan associations for the savers' dollar.

In Los Angeles, Lytton Financial Corp., a savings and loan holding company, announced plans to offer savers who keep a minimum of $1,000 in its association three years an annual dividend rate of 5.35 per cent, or a half percentage point above the usual 4.85 per cent.

DETROIT S&L MOVES

In Detroit, First Federal Savings, the largest in Michigan, said it will increase its payments by a quarter of a percentage point, to 4½ per cent, on regular savings accounts Jan. 1.

The announcements came in the wake of the Federal Reserve Board's Dec. 5 action increasing to 5½ from 4½ per cent the maximum interest commercial banks may pay on time deposits maturing in 30 days or more.

Since the ceiling was lifted, a number of major banks around the nation have boosted their interest on longer maturity certificates of deposit sold in the money market to 4.75 from the former 4.5 per cent limit. A few small banks said they will pay 5 per cent on certificates.

First National City Bank, New York's largest, and Bankers Trust Co., its sixth biggest, raised by a quarter of a percentage point the top rate on non-negotiable "savings certificates" that they issue only in amounts of $2,500 or more. Both banks increased to 4½ from 4¼ per cent the rate on certificates maturing in six months or

5%
CURRENT ANNUAL RATE
BANK INTEREST
On Time Deposit Open Accounts and Time Certificates of Deposit in amounts of $1,000 or more when held a minimum of 90 days.
ACCOUNTS FEDERALLY INSURED BY THE FEDERAL DEPOSIT INSURANCE CORP.
SAVE-BY-MAIL
WE PAY POSTAGE BOTH WAYS
A STATE CHARTERED BANK
INDEPENDENCE BANK
21044 SHERMAN WAY
CANOGA PARK, CALIF.
CALL, WIRE OR WRITE.
CARL O. SCHATZ, President
340-7225 OR TOLL FREE 873-3691

Foreign Rates Rise Due To U.S. Action

Dow Jones News Service

LONDON — European loan rates are rising under pressure of capital demand by United States companies. Funds are going to finance overseas operations of American concerns. The net effect is a considerable tightening of Europe's money markets, with European firms reporting difficulties in finding new funds

"Borrowing rates are at an unprecedented level," said one European financial observer.

Bankers across Europe reported that the pace of U.S. company bonds offered in Europe has accelerated sharply in recent weeks. So great has been the demand for funds by American firms that the general "going" interest rate has climbed to 6¼ per cent and companies in Britain have been obliged to pay coupon rates around 7 per cent on new debenture offerings.

* * *

TOKYO (Reuters) — Japanese banks yesterday raised the interest rate on short-term credits in foreign exchange supplied to importers ¼ per cent, ranging to 7 and 7¼ per cent, as a reaction to the increase in the American bank discount rate.

* * *

TORONTO (DJ) — The Toronto-Dominion Bank announced its prime interest rate had been increased to 6 per cent from 5¾.

as long as Rails refuse to confirm Industrials on the downside (a downside confirmation would entail a move by Rails into the 235 area)."

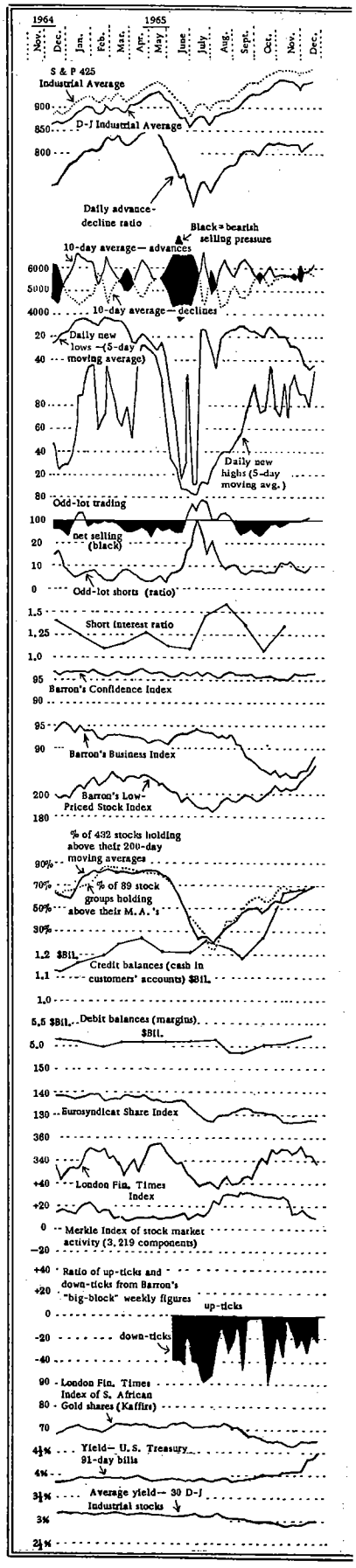
What has actually occurred? Since November, Rails not only have refused to confirm Industrials on the downside but on session after session the carriers have succeeded in establishing new record highs (see Chart 1). The peak of the divergence came on December 6. On that day, in response to the interest rate boost, the Industrial Average sunk to a low close of 939.53. That low was immediately followed by a high volume rally. On the rally (which began on December 7) the two Averages advanced together for the first time since September. On December 17 (Friday) Industrials closed at 959.13, just a point short of the early November high. On the same day Rails closed at an all-time peak of 249.55. Last week opened in ragged fashion with the Industrials backing away from their November high.

Conclusion: An Industrial close above 961.85 would reconfirm the primary bull trend. As long as one or both Averages hold above the 939.53 and 240.89 levels, the secondary trend will be considered bullish (see Chart 1). A joint closing below those points, however, would mean a bearish designation for the secondary trend.

Two notes of caution: (1) despite week after week of record volume it is well to remember that Industrials are still only 2% above the May peak of 939.62, a peak that was established seven months ago. (2) I have commented frequently about the Utility Average, which in the past has tended to lead market recoveries. On December 20, however, Utilities broke through the 150 level to close at their lowest point since August, 1964.

* * * *

The Composite Chart (at right) shows the two leading industrial averages fractionally below their early November high. On Friday, December 17, the A-D ratio rose to a new recovery high above its November peak but still below the earlier May peak. This presents the interesting picture of a double upside non-confirmation. The A-D ratio has failed to better the May peak (it has therefore refused to confirm Industrials over the longer term.) Industrials have not so far bettered their early November 961.85 high (Industrials have therefore refused to confirm the A-D ratio over the shorter term). There is a strong seasonal bias toward odd-lot (tax) selling in late December so this indicator can be discounted for now. The Low-Priced Stock Index has risen to a new 1965 high. The London Index has dropped sharply to the 338 level (most of the European stock indices are now doing poorly with Holland, Belgium, Austria and Germany closing last week at new 1965 lows). Barron's Big Block ratio for the week ending December 17 was minus 21. The spread between the yield on the 91-day Treasury bills and the DJI is now 1.54, greatest in history. Conclusion: The trend of the D-J Averages is bullish. Nevertheless, I now consider the relationship between the A-D ratio and the Industrials potentially quite bearish. The monetary pressures on the market must now be considered bearish.



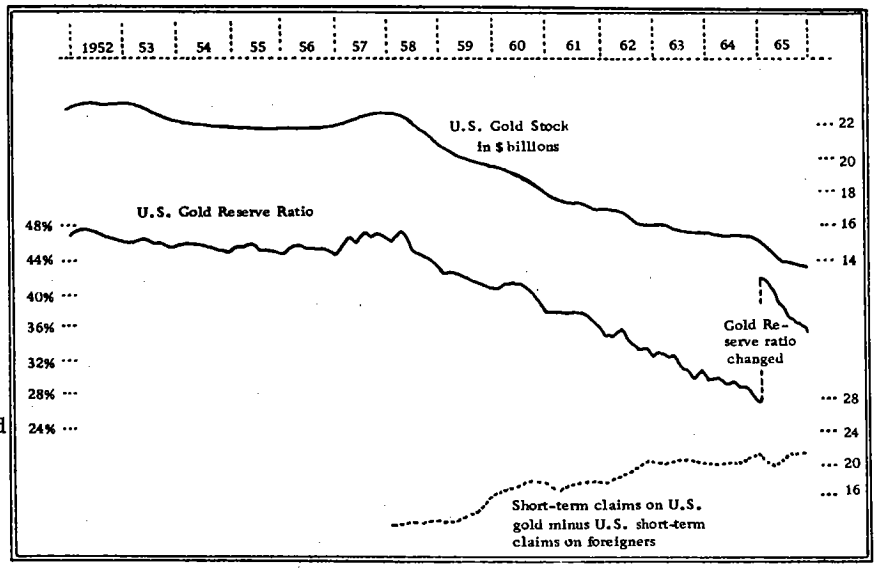
GOLD AND DOLLARS: The gold chart on Page 3 tells a dramatic story, a story of the deteriorating position of the dollar as the leading currency in the world. Through five thousand years of recorded history, the measure of a nation's currency has been the stability of that currency's purchasing power and the manner in which the currency has withstood the inroads of political "tampering" and inflation. Throughout history the strength of a nation's currency has been an excellent gauge of the wealth and greatness of a country. When currencies fall, nations fall, be they the Roman Empire, post World War I Germany or a South American "banana republic."

So true is this that one can actually trace the changes in the international balance of power through the rises or declines in the various nations' gold stock. A strong, competitive, aggressive country tends to accumulate gold, while a country which is plagued by inflation, rising costs, ineffective budget control and political ineptitudes tends to lose gold.

Thus the U. S. monetary position was almost impregnable after World War II. In 1950 when the great boom began the U. S. had $23 billion in gold to back its currency. Fifteen years of boom, give-away and creeping socialism followed. As of last month the U. S. gold stock had dropped to $13.8 billion (see top line on chart). Compare this with the European experience. In 1950 France held $600 million in gold, Germany had $28 million, Belgium $587 million, Holland $311 million. The total of all four of these nations' gold holdings was negligible. At the same time, the sum total of their political power (with the rest of Europe thrown in) was also negligible. But by the end of 1964 France's position had improved to where she held well over $5 billion in gold and foreign reserves, Germany had over $6 billion in gold and reserves, Belgium $1.9 billion and Holland $2 billion.

The most dramatic changes have actually occurred since 1958. Since then France has increased her gold and foreign reserve position by 376%, Germany by 21%, Belgium by 30%, Holland by

41%. During the same period the U. S. position has dropped 21%. In view of this, one wonders whether it is a coincidence that France has become the power in Europe to reckon with. Is it mere coincidence that the Common Market nations now possess the power to veto U. S. monetary plans and aspirations?



Not only have foreign nations been building up their holdings of gold and reserves, but they have been moving to increase the percentage of gold to total reserves. It should be remembered that when nations do this they are foresaking interest income which they could collect on their foreign holdings (holdings are largely dollars held in the U. S.) in favor of the safety of gold. The continuing buildup in foreign gold stocks is continuing proof of foreign central bankers' fears of ultimate trouble for the dollar. Furthermore (and perhaps ironically) the greater the gold holdings of such countries as Germany, France, Holland, Belgium and Spain, the less interested these nations will be in any "gold reduction" or "paper money" schemes for the dollar. Thus we have the spectacle of U. S. Treasury Secretary Fowler rushing about on an endless speaking spree, talking ad finitum but accomplishing almost nothing in the way of "monetary reform." Foreign nations are simply not interested.

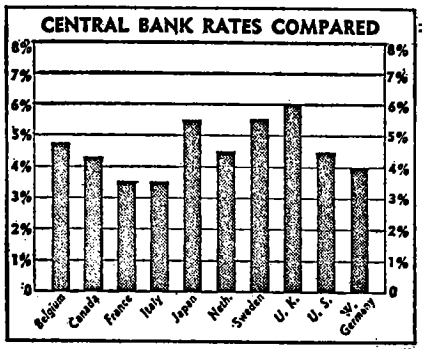
The second indicator on the chart tells another important story. Under pre-1965 law, all U. S. currency plus all deposits in Federal Reserve Banks required backing of 25% or more in gold. In March, due to massive gold losses and simultaneous expansion of the money supply, the legal reserve margin dropped so low that an immediate change in the ratio was necessitated. A new law was rushed through Congress. The new law eliminated gold backing for the Federal Reserve Bank deposits, retaining gold backing only on the currency. This change had the effect of immediately raising the gold reserve ratio to 43%, a "safe" distance above the critical 25% level.

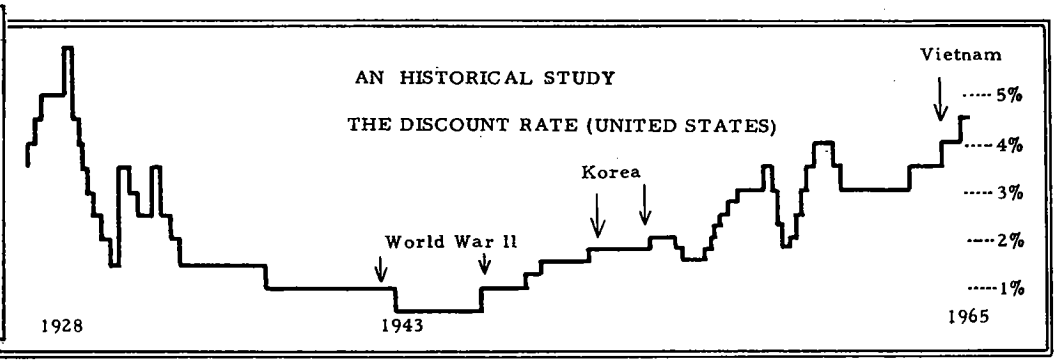
But U. S. monetary policies continued unchanged. And in the eight months since March, 1965, the ratio (due to more gold losses and more expansion of the money supply) has dropped a whopping 7. 5% to 35. 5%! This is a shocking decline, and at the current rate the legal ratio should be touched again by late 1966. Since Foreign interests hold great quantities of currency in the form of short-term claims, we can imagine how closely they are now scrutinizing our gold ratio.

The last line on the chart shows the progress of net foreign claims against U. S. gold. This indicator has been steadily rising, but it has recently leveled off. The important factor to note here is that although the gold stock has been falling, short-term claims are holding level. This means that instead of building up further short-term claims, foreigners are simply calling in gold. In the third quarter of 1965, for instance, despite a windfall inflow of $132 million in gold from Britain (from Russian gold sales), France took $117 in U. S. gold, Spain took $30 million, Austria $37 million, Belgium $21 million, Australia $8 million, and there were smaller sales to such assorted countries as Costa Rica, Brazil, Egypt, Iran, Ireland, Turkey and Syria. On balance the U. S. lost $95 million in gold during the third quarter.

Conclusion: the chart suggests that within the next year either the U. S. is going to reverse its whole stance, turn conservative and defend the dollar by cutting way back on spending, boosting interest rates and shrinking the money supply — or there is going to be a further and vastly more critical run on our remaining gold.

CHARTS OF THE WEEK: In Letter 272 I published a chart showing central bank rates (the rate at which the banks borrow from their central banks) of the various nations throughout the Free World. The smaller chart brings this study up to date, and as can be noted most of the rates are at or above the rates of a year ago. Most important, the two "soft-money" nations, the U. S. and Britain, have been forced (despite Administration desires to the contrary) to move their bank rates up. Nothing like this chart has been seen in a





generation. It should be remembered that just as commercial banks, savings & loan associations and savings banks are fighting for new funds on the domestic front, so in the international sphere nations are now struggling with other nations to hold their respective monetary reserves through the mechanism of higher interest rates. Thus, interest rates might be termed the "timperature gauges" of the world's money market. The temperatures are currently running high.

The second chart is self-explanatory. However, it is worth noting that in 1940 as World War II was starting the U. S. Federal debt was $53 billion. This debt was not too expensive to "carry," for the discount rate was then at or below 1%. In 1950 when Korea began the national debt had increased to $266 billion and the discount rate had risen to 2%. Currently the national debt is around $325 billion and the discount rate has risen to 4½%. Both the debt and the cost of financing the debt have sky-rocketed. Baron Rothschild once commented that "the eighth wonder of the world is compound interest." Those who manage the U. S. debt are about to discover the truth of the Baron's statement.

LATE NOTES: It was announced that the short interest rose another 1.8 million to another record high. How much of this is "hedging" or "shorting against-the-box" (this is a method of capturing profits by shorting stocks which are already owned) is not known. My own guess is that there has been a good deal of such shorting — if so, the total short interest will drop substantially in January. At any rate, the new high in the short interest should be taken as bullish as long as the bull market is in force (for shorting today is certainly shorting against the established trend).

* * *

WHAT THEY'RE SAYING: (from the December 14 Janeway Service by "The moment Viet Nam inflated into a big issue, the remoteness which gave Johnson his freedom of action turned into a liability. Altogether, it's worth recalling 1938 — when, with millions of different groups up in arms against the aggressors and their infamous axis with the Communists, the best Roosevelt could play for was a tie before anybody got hurt. In Viet Nam, McNamara has hung Johnson up without a mass base to support the war at home, and without a plausible target for our effort overseas. Our policy target is as vague as the target for our bombings has been. Up to this point, McNamara has been able to bull his way forward in defiance of Congressional scepticism or criticism on the theory that 'Johnson will fix all complaints.' This phase is now over. If Johnson can't get his Viet Nam problem under control, 1966 will be an even rougher year for him than 1938 was for Roosevelt."

(From Schaefer's "Dow Theory Trader," Dec. 18) "It would not surprise me to see another increase in the total short interest to another all-time high. If so, we can look for a real battle on huge volume between the bulls and the bears during the first half of 1966. Since perhaps the majority of bulls are new-comers to the market, and are ruled most by their emotions, my guess would be that we will witness some ridiculous upmoves and a feverish 'top area' well into late spring and summer of next year. The situation could be similar to, but much wilder than, the late Spring top of 1959."

(From the new December Alden R. Well's Monetary Report) "The professional controls more money and is more knowledgeable than the trading public. He notes that although the money supply increased 9% this past year, the stock rise of 7% was for the first time less. He also notes that money rates increased 30%. The gap between income from stocks and income from the money market widened materially. Shifts toward the money market should, of course, increase, led, we believe, by the more astute professionals.

"Except in inflationary periods, stocks yield more than bonds. Should the normal relationship develop, stock prices would be cut in half. The bond market clearly says that this will happen in 1966. Internal evidence in the stock market indicates that some professionals agree. We are of this opinion. How much further the stock market might decline, or whether it will rise from that level, we will report as the year progresses."

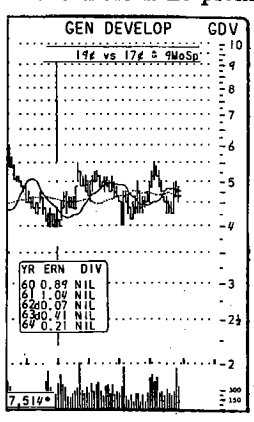
It is my own opinion that the pressure is finally on the leaders of this nation to end the war in Vietnam. Ironically, the pressure is coming not from Republicans but from Democrats and mainly from liberals and university elements across the nation. In a recent bitter attack, the influential New York Times saw fit to accuse Dean Rusk of being lax in following up Vietnam "peace feelers." Of late, many observers had the distinct feeling that Washington did not want to end the war and that the whole Vietnam situation was being used as a stepping stone from which to push the U. S. into a war with China (if you doubt that anyone wants nuclear war with China, read the Alsop article in the current Saturday Evening Post).

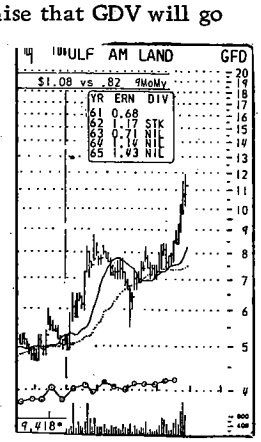
Today it was announced that Dean Rusk "may" meet with Fanfani of Italy in the U.N. in order to further explore peace feelers from Vietnam. It is believed that North Vietnam may now want peace, but that peace negotiations would have to be prepared secretly and out of China's sight. China obviously wants to prolong the war, and it is this writer's opinion that China sees the war as part of her economic battle with the U. S. China knows that continuation of the war will have the effect of bleeding this nation dry.

STOCKS: Chartcraft (Larchmont, N.Y.) lists the following five groups as strongest on the basis of relative strength and momentum studies. (1) Radio-TV Mfgs., (2) Air Transport, (3) Aerospace, (4) Machine Tools, (5) Electronics.

From an overall picture, it is now apparent that the low-priced speculative stocks as a "group" are receiving the real play, while the investment-grade issues are milling about and on balance literally standing still (the 30 Dow stocks, for instance, have made almost no progress as an average in seven months). The problem, where does one go if one wants "action"? The answer (and this will appeal to few value-minded subscribers) is to the low-priced stocks and probably to the American Exchange.

Many subscribers may remember my recommendation of Gulf-American Land (Letter 278) as a good speculative vehicle. That stock was recommended at 6¼ and has since doubled (I noted at the time that the point & figure "objective" for Gulf-American was 14.) A second stock in the speculative Florida land business is General Development. While there is no promise that GDV will go the way of Gulf American, it has "inflation hedge" appeal, and the stock is forming a large base. GDV has been holding above its all-time low of 4, and it shows signs of getting ready to "break out." If you want to buy GDV, I would suggest buying half of any projected commitment now and the other half if and when GDV moves to the 5 3/4 to 6 level.





Charts of GDV and GFD courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.